THE DEDUCTIBILITY OF "POINTS" INCIDENT TO A SALE, PURCHASE, REFINANCING, OR LEASE OF A HOME

A. POINTS.

The term "points" is sometimes used to describe certain charges paid by a borrower. They are also called loan origination fees, maximum loan charges, or premium charges. If the payment of any of these charges is only for the use of money, it is interest. A loan processing fee paid by the borrower as a bonus to get a conventional loan is deductible as interest. However, loan origination fees paid as a charge for services rendered in connection with a loan (such as a VA funding fee) are <u>not</u> considered interest.

Points paid for the use of money are interest paid in advance and generally are not deductible in full in the year paid. As a general rule, the prepaid interest must be spread over the life of the mortgage, and deducted ratably over the period of the loan.

Taxpayers may deduct the amount paid as points in the year of payment if the loan is used to buy or improve the taxpayer's main home and the loan is secured by that home. This exception applies only if--

1) The payment of points is an established business practice in the area where the loan was made;

2) The points paid did not exceed the number of points generally charged in the area; and

3) The points are paid directly by the taxpayer.

If a taxpayer paid more points than generally paid in the area, the taxpayer's deduction is limited to the points generally charged. Any additional amount of points the taxpayer paid must be spread over the life of the mortgage.

EXAMPLE

Lieutenant Don Smith borrowed $48,000 to buy his $60,000 home. He paid the lender, in addition to interest at 8%, a loan processing fee of $1,440 (three points). None of the fee was for specific services. The charging of points was an established business practice in the area and the number of points was not more than that generally charged in the area. The $1,440 loan processing fee (points) is interest. Don may deduct it in the year of payment.

EXAMPLE

Major Jan Green got a loan from a bank to buy her home. The loan was guaranteed by the Department of Veterans Affairs. Jan paid the bank a loan origination fee. The fee was 1% of the amount of the loan. It was charged in addition to the rate of interest permitted on VA loans. The 1% loan origination fee (one point) is now treated as interest. Jan may deduct it on Schedule A. (This result is effective for homes purchased on or after 1 January 1991.)

B. POINTS PAID BY THE SELLER.

The term "points" also is used to describe loan placement fees that the seller may have to pay to the lender to arrange financing for the buyer. The seller may not deduct these amounts as interest. But these charges are a selling expense reducing the amount realized. Buyers may now deduct seller-paid points on homes purchased on or after 1 January 1990. When the buyer deducts the seller-paid points, the buyer must reduce the basis of the home by the amount of the deduction.

C. REFINANCING.

Points a taxpayer pays in refinancing a mortgage, regardless of how he arranged to pay them, are not deductible in full in the year paid except to the extent they are paid in connection with the improvement of a home. This is true even if the new mortgage is secured by the taxpayer's principal residence. Annually, the taxpayer will deduct the ratable amount of interest from the points over the life of the loan.

If the taxpayer used part of the refinanced mortgage proceeds to make an improvement on his principal home and paid the points out of private funds (rather than out of the proceeds of the new loan), the taxpayer may apportion the points attributable to the amount of the proceeds used for the improvement and deduct the apportioned amount in full in the year paid. The taxpayer may also deduct the ratable portion of the amount of the points attributable to the new debt over the life of the loan.

EXAMPLE

In 1981, Captain Bill Fields obtained a mortgage for the purchase of a personal residence. The interest rate on that mortgage loan was 16%. Earlier this year, Bill refinanced this mortgage with a 15-year $100,000 mortgage loan that has an interest rate of 10%. To obtain financing, Captain Fields paid three points ($3,000). Bill paid the points out of his private funds. The payment of points is an established practice and the points charged do not exceed the amount generally charged in the area. Bill made six payments on the loan this year. Bill is a cash basis taxpayer.

Bill Fields used the funds obtained from the new mortgage to repay his existing indebtedness. Although the new mortgage loan was incurred in connection with Captain Fields' continued ownership of his principal residence, the new mortgage was not incurred in connection with the improvement of that residence. Therefore, Bill cannot deduct all of the points this tax year. So long as the loan origination fee is classified as points on the settlement statement, he can deduct the total of three points ratably over the life of the loan.

EXAMPLE

Assume the above facts, except that Captain Fields used $25,000 of the loan proceeds to make an improvement to his principal home. Because he paid the points in 199X, he is allowed to deduct, in 199X, 25% ($25,000 divided by $100,000) of the three points that represent prepaid interest. His deduction for the portion of the prepaid interest that is attributable to his home improvement is $750 ($3,000 prepaid interest X 25%). Additionally, in 199X, Bill can deduct the ratable portion of the $2,250 ($3,000 prepaid interest - $750 attributable to home improvement) that must be spread over the life of the loan. He can deduct $75 of the ratable portion of the prepaid interest in 199X ($2,250 ratable portion of prepaid interest divided by 180 months (life of the loan) X 6 payments made in 199X = $75). The total amount deductible in 199X is $825 ($750 + $75). If Bill makes all of his payments when due, his annual deduction will be $150 each year for 199X through 2006 ($2,250 divided by 180 months X 12 payments = $150). His deduction in 2007, the final year of payment, will be $75 because he will make six payments that year.

EXAMPLE

Assume the same facts from the examples above, except that Bill did not pay the points out of his private funds. Rather, the bank deducted the points from the loan proceeds. Since Bill did not actually pay the points, he cannot apportion the three points which are prepaid interest to the portion of the loan used to make home improvements. Captain Fields must spread the three points ($3,000) ratably over the life of the loan.